Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:MAN:POSTF-162409-01
PLDarcy

date: December 12, 2001

to: Director, Field Specialists
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Director, Pre-Filing and Technical Guidance
Attn: Acting Technical Advisor A. Lee Keenan (LM:PFTG)
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from: Area Counsel (Financial Services) (CC:LM:F)

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subject: [redacted]
Taxable Years Ended December 31, [redacted] and December 31, [redacted]
U.I.L. Nos.: 41.00-00, 41.52-00, 41.52-01, 41.55-05, 41.55-09

This memorandum responds to your request for assistance dated November 8, 2001 concerning the section 41[1] credit for increasing research activities ("section 41 credit") computation of [redacted] ("Taxpayer") for the taxable years ended December 31, [redacted] and December 31, [redacted].

The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us. This advice is subject to National Office review. We will contact you within two weeks of the date of this memorandum to discuss the National Office's comments, if any, about this advice. This memorandum should not be cited as precedent.

ISSUE

1. How should the Taxpayer compute its base amount for the taxable years ended December 31, [redacted] and December 31, [redacted]?

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended.

CONCLUSION

The Taxpayer must compute its section 41 credit on an aggregate basis. That is, to compute its base amount, the Taxpayer must first aggregate each member's base years' qualified research expenses ("QREs"), base years' gross receipts, and average annual gross receipts for the prior four years. In calculating its base amount for all taxable years ending after acquiring 100 percent of a trade or business, the Taxpayer must include 100 percent of the acquired business' base years' QREs, base years' gross receipts, and average annual gross receipts for the prior four years.

FACTS

The Large and Mid-Size Business Operating Division is currently auditing the Taxpayer's taxable years ended December 31, [redacted], December 31, [redacted] and December 31, [redacted]. During [redacted], the consolidated group's parent, acquired [redacted] percent of the outstanding shares of [redacted] Inc., [redacted] Inc. and [redacted] Inc. These entities were all viable businesses and became part of the Taxpayer's consolidated group.

The examination team has expressed concern as to how the Taxpayer computed its base amount for the [redacted] and [redacted] taxable years. The parties agree that the Taxpayer is a "controlled group of corporations." See I.R.C. § 41(f)(5). The Taxpayer, however, computed its base amount on a "single entity" basis by adding the base amount of each member to arrive at the consolidated group's base amount. The Taxpayer claims that its consolidated group's base amount equals the sum of its members' individual base amounts. Additionally, in computing its base amount for the [redacted] taxable year, the Taxpayer now proposes to prorate the average annual gross receipts for the prior four years of [redacted] Inc., [redacted] Inc. and [redacted] Inc. by a fraction equal to the number of months [redacted] owned these entities in [redacted] over [redacted].

APPLICABLE LAW

Section 41 allows taxpayers a credit against tax for increasing research activities. Generally, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's QREs for the taxable year over the base amount, and 20 percent of the taxpayer's basic research payments determined under section 41(e)(1)(A)[2]. For tax years beginning after December 31, 1989, the base amount is computed by multiplying the taxpayer's fixed-base percentage by its average annual gross receipts for the preceding four years. I.R.C. § 41(c)(1). In general, a taxpayer's fixed-base percentage is the percentage which the aggregate QREs of the taxpayer for taxable years beginning after December 31, 1983, and before January 1, 1989, is of the aggregate gross receipts of the taxpayer for such taxable years. I.R.C. § 41(c)(3)(A).

The research credit provisions originally appeared in section 44F of the Internal Revenue Code of 1954, as added to the 1954 Code by section 221 of the Economic Recovery Tax Act of 1981 (the 1981 Act). Section 471(c) of the Tax Reform Act of 1984 redesignated section 44F as section 30. Section 231 of the Tax Reform Act of 1986 redesignated section 30 as section 41 and substantially modified the research credit provisions. Congress revised the computation of the research credit in the Revenue Reconciliation Act of 1989 (the 1989 Act).

Section 41(f)(1)(A)(i) and Proposed Treasury Regulation § 1.41-8(a)(1) require that for purposes of determining the amount of the research credit, all members of the same controlled group of corporations are to be treated as a single taxpayer. These sections specifically prohibit computation of the section 41 credit on a single entity basis. The research credit allowable to any member of the controlled group is equal to that member's proportionate share of the qualified research expenses and basic research payments giving rise to the credit. I.R.C. § 41(f)(1)(A)(ii).

Proposed Treasury Regulation § 1.41-8 provides guidance on how a controlled group should compute its section 41 credit. The Proposed Treasury Regulation is generally applicable for taxable years ending on or after January 4, 2000. 65 F.R. 258, 260 (January 4, 2000). However, the interpretation set forth in

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[2] Under Section 41(c)(2), however, the minimum base amount is 50 percent of the credit year qualified research expenses.

Proposed Treasury Regulation § 1.41-8 reflects changes to section 41 made by the 1989 Act. 65 F.R. 258, 259. When a controlled group of corporations computes its base amount, the group must first aggregate each member's base years' QREs, base years' gross receipts, and average annual gross receipts for the prior four years. Prop. Treas. Reg. § 1.41-8(a)(6)(i), Example 1. The group's current year QREs is equal to the aggregate of each member's current year QREs. Id.

As originally enacted in 1981, the research credit contained rules for computing the research credit where a business changed hands. The legislative history to the 1981 Act explained that the rules were intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer. If section 41 had not included rules for changes in ownership of a business, a taxpayer who began a business by buying and operating an existing company might be entitled to a credit even if that taxpayer had not increased the amount of qualified research expenditures. Also, the sale of a unit of a business might have caused the seller to lose any research credit even though the seller had increased the qualified research expenditures in the part of the business that the seller had retained. H. Rep. No. 97-201, 1981-3 C.B. (Vol. 2) 364 and Sen. Rep. 97-144, 1981-3 C.B. (Vol. 2) 442.

In the 1989 Act revisions to the computation of the research credit, the House Report simply states that the rules relating to the aggregation of related persons and changes in ownership are the same as under present law with the modification that when a business changes hands, qualified research expenses and gross receipts for periods prior to the change of ownership are treated as transferred with the trade or business which gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage. H. Rep. No. 101-247, reprinted in 1989 U.S.C.C.A.N. 1906 at 2672.

Thus, section 41(f)(3) includes special rules for computation of the credit where there is a change in ownership of a trade or business after December 31, 1983. Treasury Regulation § 1.41-6(a)(2) provides that a trade or business includes a corporation that is carrying on a trade or business. Section 41(f)(3)(A) provides that if a taxpayer acquires a trade or business of another person (hereinafter the "predecessor"), then, for purposes of applying section 41 for any post acquisition taxable year, the taxpayer's QREs and gross receipts must be increased by the predecessor's relevant QREs and gross receipts.

ANALYSIS

The Taxpayer must compute its section 41 credit on an aggregate basis. I.R.C. § 41(f)(1)(A)(i). That is, to compute its base amount, it must aggregate each member's base years' QREs, base years' gross receipts, and average annual gross receipts for the prior four years. Prop. Treas. Reg. § 1.41-8(a)(6)(i), Example 1. The Taxpayer correctly argues that Proposed Treasury Regulation § 1.41-8 does not generally apply to the years at issue in this case. However, based upon the interpretative nature of these proposed regulations, coupled with their interpretative consistency with the final regulations issued with respect to the old "rolling base period" rules for taxable years ending on or before December 31, 1989, Treas. Reg. § 1.41-6, it is appropriate for the examination team to apply them in this case. See IRM 4.2.7.3.4(3)("When no temporary or final regulations have been issued, examiners may use a proposed regulation to support a position."). Furthermore, the Taxpayer's attempt to compute its base amount using a single entity approach clearly contradicts the section 41(f)(1)(A)(i) and has no basis in law.

In computing its base amount for [redacted], the Taxpayer must include [redacted] percent of [redacted] Inc.'s, [redacted] Inc.'s and [redacted] Inc.'s base years' QREs, base years' gross receipts, and average annual gross receipts for the prior four years. Any attempt to prorate the average annual gross receipts for the prior four years of [redacted] Inc., [redacted] Inc. and [redacted] Inc. clearly contradicts the clear language of section 41(f)(3)(A).

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views. If you have any questions regarding the above, please contact Paul Darcy of this office at (212) 436-1469.

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By: _____
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